

# SBC Provides Residential Universal Service While IXC's "Cherry Pick" Profits

IXC offers target premium customers rather than universal service.

## Ameritech Residential Customer Spending

		Ave Rev per Line	% of Total SBC Revenue	% of Total SBC Profit
IXCs	Quartile 1	\$43-\$54	36%	72%
	Quartile 2	\$36-\$43	29%	41%
SBC	Quartile 3	\$24-\$36	21%	9%
	Quartile 4	\$0-\$24	14%	(22)%

SBC's resulting customer base will be unprofitable, with no funds for investment.

# Clear IXC Strategy

## No Capital Investment

**"... gives AT&T Consumer unmatched leverage to create offers ... without making economic sacrifices."**

*Betsy Bernard,  
President, AT&T Consumer*

**"We're profitable everywhere we sell because we limit ... where we sell based on cost.... [W]e're deploying very little capital to make it work."**

*Wayne Huyard  
COO, MCI*

**"We do not expect that the growth of our business will require the levels of capital investment in fiber optics**

**and switches that existed in historical telecommunications facilities-based models."**

*10-Q Filing  
Z-Tel*

## High Margins, Low Risk

**"Our principle of maximizing cash requires that we only enter states that meet our gross margin requirements."**

**"We are not going into states where we don't have a gross margin of 45% on the local ...."**

*Betsy Bernard,  
President, AT&T Consumer*

# Capital Market Reaction

## Stock Prices

	Before UBS Warburg Report (08/19/02)	After UBS Warburg Report (08/23/02)	Percent Change
SBC	\$29.87	\$26.30	(12.0)%
AT&T	\$10.76	\$12.22	13.6%

**"We believe SBC has the most attractive region for UNE-P providers. SBC takes the hardest hit for each retail line lost to UNE-P competitors ... SBC has lost more retail lines to UNE-P than any other Bell, at 3.45 million... [and we] expect SBC to lose 1 million retail lines to UNE-P in the third quarter of 2002."**

**- UBS Warburg**

# **Summary**

**Bill Daley  
President  
SBC Communications Inc.**

# **Impacts**

**Reduced Service Quality**

**Reduced Ability to Provide Service to all Customers**

**No Incentive To Invest in Networks**

**Eliminated Jobs**

**Slower Deployment of New Services**

**Increased Cost of Capital**

**Weakened Equipment Suppliers**

# **Next Steps**

- **Current regulatory regime regarding UNE-P and pricing is unsustainable**
- **Turmoil in industry calls for quick and decisive action**
- **As long as we have carrier of last resort obligations, prices must be set to recover our costs**
- **There are many ways to solve this problem, but time is extremely short. Whatever direction the FCC moves, it must be effective in a very short period of time**

# Key Analyst Reports on UNE-P

August 2002



August 20, 2002

Telecommunications--Wireline

United States

## SBC Communications, Inc. (SBC) [2,37.80]

Hold

### Key Statistics

Price	\$29.87
52-Wk Range	\$47.25-\$29.87
Price Target	\$30.00
Return Potl.	4.0%
Mkt. Cap(MM)	\$99.321
Sh. Out(MM)	3,325.1
Float	100%
Inst. Hldgs.	47.0%
Avg. Volume(K)	8,503
Cur. Div./Yield	\$1.08/3.6%
Sec. Growth Rate	3%
Convertible?	No

### Quarterly Earnings Per Share (fiscal year ends December)

	2001A	2002E	Prev	2003E	Drpt
1Q	\$0.51	\$0.51A		\$2.25	\$2.36
2Q	0.61	0.61A		\$2.36	
3Q	0.59	0.58			
4Q	0.64	0.61			
Year	\$2.35	\$2.31			
FC Const.	\$2.35	\$2.30			
P/E:	12.7x	12.9x			
Revs.(MM):	\$45,908	\$43,325			
				\$42,308	

SBC Communications through its brands—Southwestern Bell, Ameritech, Pacific Bell, SBC Telecom, Nevada Bell, SNET and Cingular—provides local and long distance wireline service, wireless and data communications, high-speed internet access and messaging services, as well as directory advertising and publishing. SBC is the second-largest U.S. local service provider. Cingular Wireless, its 60-40 joint venture with BellSouth (SBC has 60%), is the second-largest U.S. wireless provider, with more than 22 million subs.

Source: UBS Warburg, LLC and First Call consensus estimates. Revenues do not include proportionate share from Cingular.

### SBC: Downgrading to Hold from Buy Based on Competitive Fears from UNE-P

#### Summary

**DETAILED UNE-P STUDY.** We have completed an analysis of UNE-P based economics from a Bell perspective and found 1) economics per line lost is worse than expected, with the average wholesale line producing negative EBITDA in SBC's region, 2) line loss is expected to grow rapidly as we estimate the company will lose 1M to UNE-P in the third quarter alone and 3) the long distance opportunity is only a partial offset as the EBITDA effects of UNE-P are hard to counter with low margin LD.

#### Action

**DOWNGRADE TO HOLD.** We are downgrading shares of SBC to Hold from Buy based on our UNE-P analysis. We anticipate that the growth of UNE-P will have a significant impact on SBC's 2003 earnings and that it will be difficult for the company to hit the Street's growth expectations for the year.

#### Valuation

**LOWER PRICE TARGET TO \$30.** Our new price target of \$30 per share (prev. \$36) is based on our discounted cash flow analysis. This lowered target incorporates changes to our models to reflect the effects of UNE-P based competition.

#### Additional Information

We will be holding a conference call to discuss our analysis of UNE-P economics for the Bells on August 20<sup>th</sup> at 11:00am. Dial-in information is 800-665-0430 in the U.S. or 913-981-5591 international.

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Companies mentioned and disclosures at end of note

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**SBC - In the UNE-P Wheelhouse**

SBC has lost more retail lines to UNE-P than any other Bell at 3.45 million, including 692,000 in the second quarter alone. The 692,000 UNE-P lines equate to 1.27% of SBC's 54.8 million total retail access lines at the end of the first quarter while the imbedded base equates to 5.9% of the company's total switched lines (including wholesale). In the second quarter, SBC added 494,000 residential UNE-P lines, representing more than 51% of the loss in the retail residential line base. Second line losses accounted for another 26% of retail residential line losses while management suggested seasonality contributed the bulk of the remainder.

**Table 1: Access Lines Statistics for SBC (000s)**

	1Q01	2Q01	3Q01	4Q01	1Q02	2Q02
Total access lines	61,254	60,578	60,230	59,532	59,036	58,255
% growth	-2.5%	-3.7%	-4.0%	-4.7%	-5.0%	-4.7%
Net Adds	-16	-676	-348	-698	-496	-781
UNE-P	1,373	1,760	2,159	2,403	2,761	3,453
Net Adds	361	387	399	244	358	692
% of total lines	2.2%	2.9%	3.6%	4.0%	4.7%	5.9%
Retail residential lines	35,878	35,255	34,946	34,518	34,129	33,168
% growth	-2.6%	-3.7%	-3.8%	-4.3%	-4.9%	-5.9%
Net Adds	-200	-623	-309	-428	-389	-961
Residential UNE-P	70	94	89	92	162	656
Net Adds	-6	24	-5	3	70	494
% of res lines lost	-3.0%	3.9%	-1.6%	0.6%	17.9%	51.4%

Source: UBS Warburg LLC estimates

**We believe SBC has the most attractive region for UNE-P providers.** The average monthly bill for local service is among the highest while its UNE-P rates are the lowest, making it relatively easy for competitors to earn decent margins. This is especially true in the Ameritech region. Ameritech and California also have a large number of dense urban areas with very low loop rates that provide ample feeding ground for resellers.

**Based on our analysis, SBC also takes the hardest hit for each retail line lost to UNE-P competitors.** We estimate that the company loses approximately \$19.76 in net revenue per line per month for each retail line lost to competitors. This compares to \$17.89 for Verizon, \$18.29 for BellSouth and \$14.73 for Qwest. In the Ameritech region, where the company is under full-scale attack, the company loses approximately \$21.73 per line per month in net revenue. The EBITDA impact is also most severe at SBC. We believe the company generates over \$13.53 in EBITDA per retail residential line per month but loses roughly \$3.51 in EBITDA per month on lines converted to wholesale via UNE-P. SBC is the only Bell to generate more than \$1.00 of negative EBITDA per month on its wholesale line base. Thus the negative EBITDA swing from retail to wholesale is more than \$17.00 per line per month, also the largest for the Bells with the other three in the -\$12 to -\$16 range. In the Ameritech region, this figure is approximately -\$19.00 per line.

**Line losses to UNE-P have shifted from the business to the residential market.** In the second quarter, UNE-P took 494,000 residential lines and just 117,000 business lines, down from 393,000 business lines in the first quarter. Michigan was hit hardest with 184,000 lines converted from retail to wholesale in the state during the second quarter. **AT&T, which began marketing in January 2002, claims to have garnered 6% residential market share in Michigan six months.** Texas has seen the largest total line loss to date from UNE-P with over 1.57 million wholesale lines (both UNE-P and TSR) in the state. Wholesale net adds have slowed dramatically in Texas, however, as AT&T has pulled back on its marketing efforts due to relatively low discounts available.

We expect line loss to continue to ramp up in SBC territory in the second half of 2002 and believe the company will lose approximately 1 million retail lines to UNE-P in the third quarter. We believe that roughly half of the line loss in the second quarter occurred in the month of June. Considering the steep growth within the second quarter and AT&T's entry into the Ohio and Illinois markets in mid-June and the California market in early August, our numbers could prove conservative. With another 1.2 million UNE-P line projected for the fourth quarter, we now expect residential line loss of 9.1% and 12.6% in the third and fourth quarter, respectively. This also suggests that by year end, 10% of total switched access lines will be UNE-P. Again, we note that our analysis suggests that wholesale lines generate negative EBITDA on a weighted average basis. In 2003, we expect the company to lose 3.41 million lines, up from 3.25 million for all of 2002.

Much depends on the company's ability to secure long distance approval in California in the near term, which should dampen (but by no means eliminate) line loss while helping to offset much of the revenue loss, similar to the results in 271-approved Southwestern Bell states. The Administrative Law Judge (ALJ) in California has approved the company's application and the full public utility commission is expected to vote on September 19<sup>th</sup>, a short delay from the recently proposed date of August 22<sup>nd</sup>. A positive outcome for the Bell could enable SBC to begin marketing interLATA services in California in late December. Ameritech is a different story however, as we do not expect the company to receive approval for long distance in these states until the second half of 2003.

### Estimates and valuation

Based on changes to our model resulting from this analysis, we are reducing our 2003 EPS estimate to \$2.25 from our previous estimate of \$2.36, while maintaining our 2002 EPS estimate at \$2.31. This translates to a 2.3% decline in EPS in 2003 versus our previous estimate for 2.1% growth. It compares unfavorably with the 1.8% EPS decline we continue to expect for 2002. We now expect total proportionate revenues to decline by 1.3% in 2003 following the 3.9% decline in 2002. Our previous estimate was suggesting a 1.1% growth in revenues. We now expect EBITDA to decline by 1.9% versus our previous assumption for a 0.5% growth in 2003.

SBC is currently trading at roughly 13.3x our new estimates for 2003. Given that we do not expect the company to generate enough growth to reach its 2001 EPS of \$2.35 until 2006, we believe it will be difficult for the company to outperform the market at these levels. In calculating our new 12-month price target of \$30 per share, we conducted a discounted cash flow analysis, employing a 7% discount rate, a terminal value that assumes 2.5% perpetuity growth and a 20% private market discount.

Table 2: Changes to SBC Estimates (\$MM)

	2002				2003				% growth	
	Old	New	\$ change	% Change	Old	New	\$ change	% Change	Old	New
Wireline Revenue	38,768	38,601	-167	-0.4%	38,864	37,482	-1,402	-3.6%	0.3%	-2.9%
Total Revenue	52,372	52,205	-167	-0.3%	52,937	51,535	-1,402	-2.6%	1.1%	-1.3%
EBITDA	21,377	21,357	-20	-0.1%	21,479	20,958	-521	-2.4%	0.5%	-1.9%
Net Income	7,728	7,715	-13	-0.2%	7,811	7,462	-349	-4.5%	1.1%	-3.3%
EPS	\$2.31	\$2.31	(\$0.00)	-0.2%	\$2.36	\$2.25	(\$0.11)	-4.5%	2.1%	-2.3%

Source: UBS Warburg LLC estimates

### Statement of Risk

Risks include management's ability to execute, potential adverse changes in regulation, changes in technology, the effects of a weak economy, increasing competition and a large degree of operating leverage.

## Global rating definitions and allocation

Rating	Definition	% of companies under coverage with this rating	% for which IB services have been provided
Strong Buy	Greater than 20% excess return potential; high degree of confidence	12%	53%
Buy	Positive excess return potential	39%	38%
Hold	Low excess return potential; low degree of confidence	44%	28%
Reduce	Negative excess return potential	4%	22%
Sell	Greater than 20% negative excess return potential; high degree of confidence	1%	11%

Excess return: Target price / current price - 1 - gross dividend yield - 12-month interest rate. The 12-month interest rate used is that of the company's country of incorporation, in the same currency as the predicted return.

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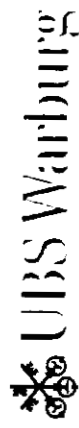
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## The Regional Bells: How Much Pain from UNE-P?

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# UNE-P Economics: Downgrading the Bells

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## ◆ Downgrading BellSouth , SBC and Verizon to Hold from Buy

- Analysis of UNE-P economics suggests pressure on profitability for the Bells
- We now expect earnings to decline 1.8% vs. prev. expectation for 2.6% growth (Street estimates are for 2-5% growth ).
- We expect long-term FCF growth of 2-3% vs prev. expectation for 3-4% growth

## ◆ Lowering Price Targets

- New price targets based on our reduced FCF estimates in our DCF analyses:
  - BellSouth: \$26 (previously \$28);
  - SBC: \$30 (previously \$36);
  - Verizon: \$34 (previously \$50)

## ◆ We Expect Market Performance Over the Next 12 Months

- Attractive dividend yields should limit downside

# UNE-P Economics : Changes to Estimates

## BellSouth

	2002				2003				% growth	
	Old	New	\$ change	% Change	Old	New	\$ change	% Change	Old	New
Wireline Revenue	18,421	18,312	-109	-0.6%	18,731	17,993	-738	-3.9%	1.7%	-1.7%
Total Revenue	29,009	28,900	-109	-0.4%	29,582	28,842	-740	-2.5%	2.0%	-0.2%
EBITDA	12,837	12,784	-53	-0.4%	13,120	12,761	-359	-2.7%	2.2%	-0.2%
Net Income	4,035	3,924	-111	-2.7%	4,217	3,836	-380	-9.0%	4.5%	-2.2%
EPS	\$2.14	\$2.09	(\$0.05)	-2.3%	\$2.18	\$2.02	(\$0.16)	-7.3%	1.9%	-3.2%

## SBC

	2002				2003				% growth	
	Old	New	\$ change	% Change	Old	New	\$ change	% Change	Old	New
Wireline Revenue	38,768	38,601	-167	-0.4%	38,884	37,482	-1,402	-3.6%	0.3%	-2.9%
Total Revenue	52,372	52,205	-167	-0.3%	52,937	51,535	-1,402	-2.6%	1.1%	-1.3%
EBITDA	21,377	21,357	-20	-0.1%	21,479	20,958	-521	-2.4%	0.5%	-1.9%
Net Income	7,728	7,715	-13	-0.2%	7,811	7,462	-349	-4.5%	1.1%	-3.3%
EPS	\$2.31	\$2.31	(\$0.00)	-0.2%	\$2.36	\$2.25	(\$0.11)	-4.5%	2.1%	-2.3%

## Verizon

	2002				2003				% growth	
	Old	New	\$ change	% Change	Old	New	\$ change	% Change	Old	New
Wireline Revenue	40,912	40,897	-15	0.0%	39,655	39,136	-519	-1.3%	-3.1%	-4.3%
Total Revenue	66,737	66,722	-15	0.0%	67,092	66,575	-518	-0.8%	0.5%	-0.2%
EBITDA	29,049	28,772	-277	-1.0%	28,836	28,160	-676	-2.3%	-0.7%	-2.1%
Net Income	8,332	8,150	-182	-2.2%	8,587	8,130	-457	-5.3%	3.1%	-0.2%
EPS	\$3.05	\$2.98	(\$0.07)	-2.2%	\$3.12	\$2.96	(\$0.16)	-5.1%	2.3%	-0.7%



## UNE-P Economics: Glossary

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### ◆ **Unbundled Network Elements (UNE)**

- The individual parts of the local telephone network (7 elements including: local loop, switches, transport and OSS) that ILECs are required to “unbundle” and lease out to CLECs. Competitors can lease out one or all of the available UNEs to provide service.

### ◆ **Unbundled Network Element-Platform (UNE-P)**

- Use of *ALL* the UNEs to provide service, requiring minimal capital outlays or asset deployment.

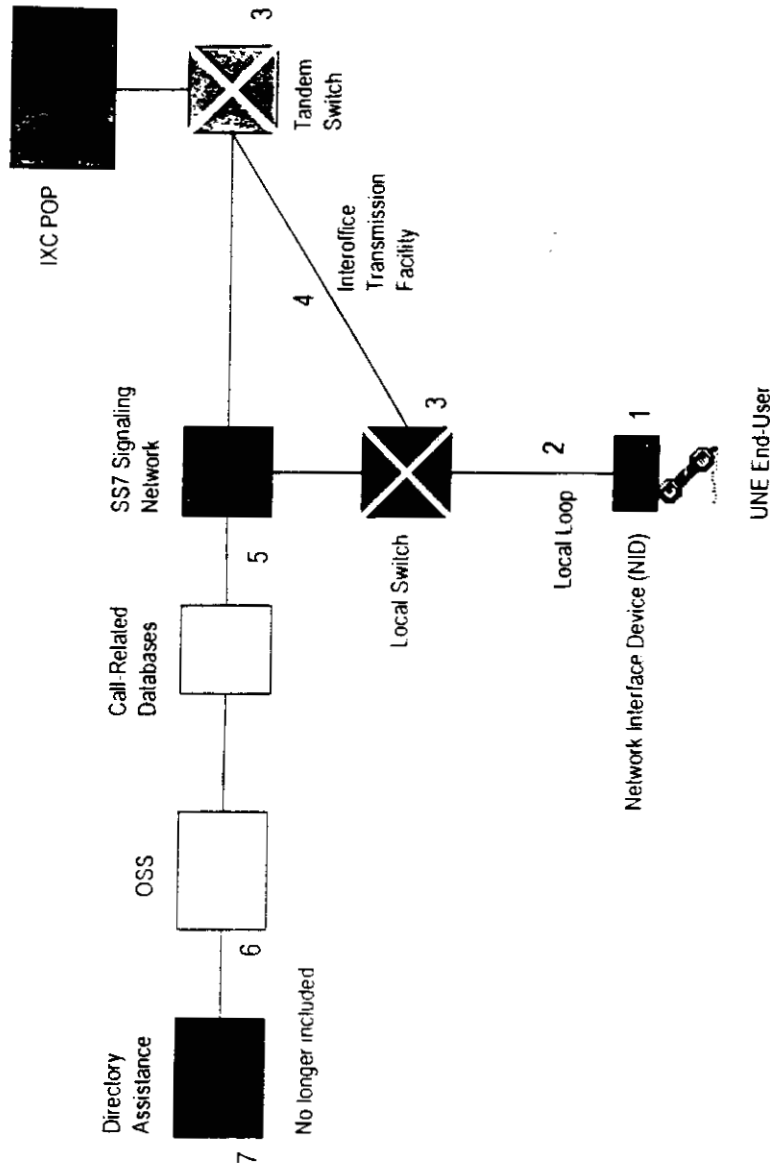
### ◆ **Retail Lines**

- Access lines sold directly to the end user from the ILEC.

### ◆ **Wholesale Lines**

- Access lines sold to competitors (AT&T and MCI), which resell the lines to end users.

# UNE-P Economics: UNE-P Diagram





# UNE-P Economics: What's the Big Deal?

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## ◆ **UNE-P Competition Has Intensified in Recent Months...**

- MCI's Neighborhood Plan (commenced in April '02; exited 2Q with 800K lines)
- AT&T (recently entered 3 SBC states [24M residential lines]; plans to enter NJ [4.5M residential lines] in Sept 2002)
- Other operators
  - Sprint is considering this strategy; others include Z-Tel, Talk America, and SupraTelecom (which added 120K UNE-P lines in FL in 2Q02)

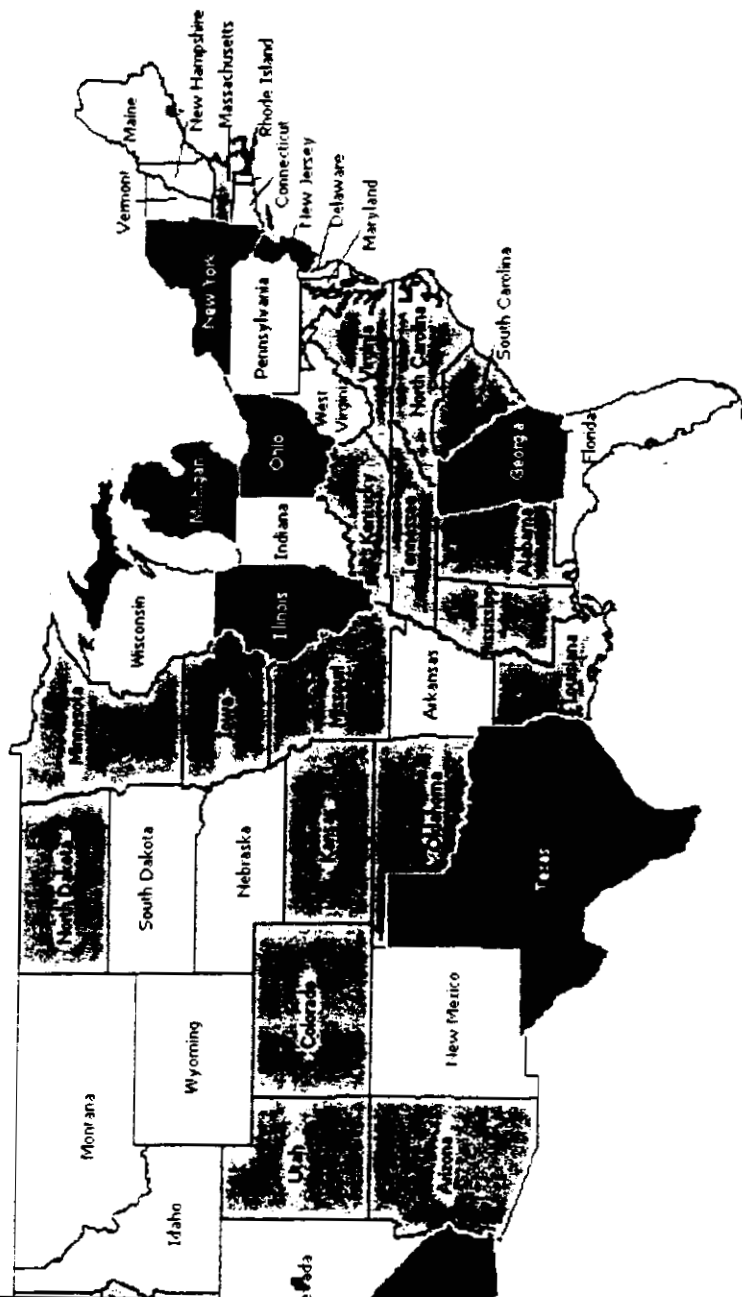
## ◆ **Due to More Favorable Economics of UNE-P for Competitors**

- Public Utility Commissions continue to set lower rates
  - Recent reductions in California, New York, New Jersey, Pennsylvania

## ◆ **Second Quarter Results Revealed the Bells' Exposure**

- Over 1.1 million retail lines converted to wholesale through UNE-P in 2Q
  - SBC: 692K added vs. 358K in 1Q02;
  - BellSouth: 278K added, vs 239K in 1Q02;
  - Verizon: 110K added vs. 64K in 1Q02

# Economics: The Rebundlers



and AT&T Operations  
 through Z-TEL and AT&T Operations  
 operations through Z-TEL  
 operations  
 operations

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# UNE-P Economics: Summary Findings

## ◆ Economics of UNE-P are Worse than We Originally Expected

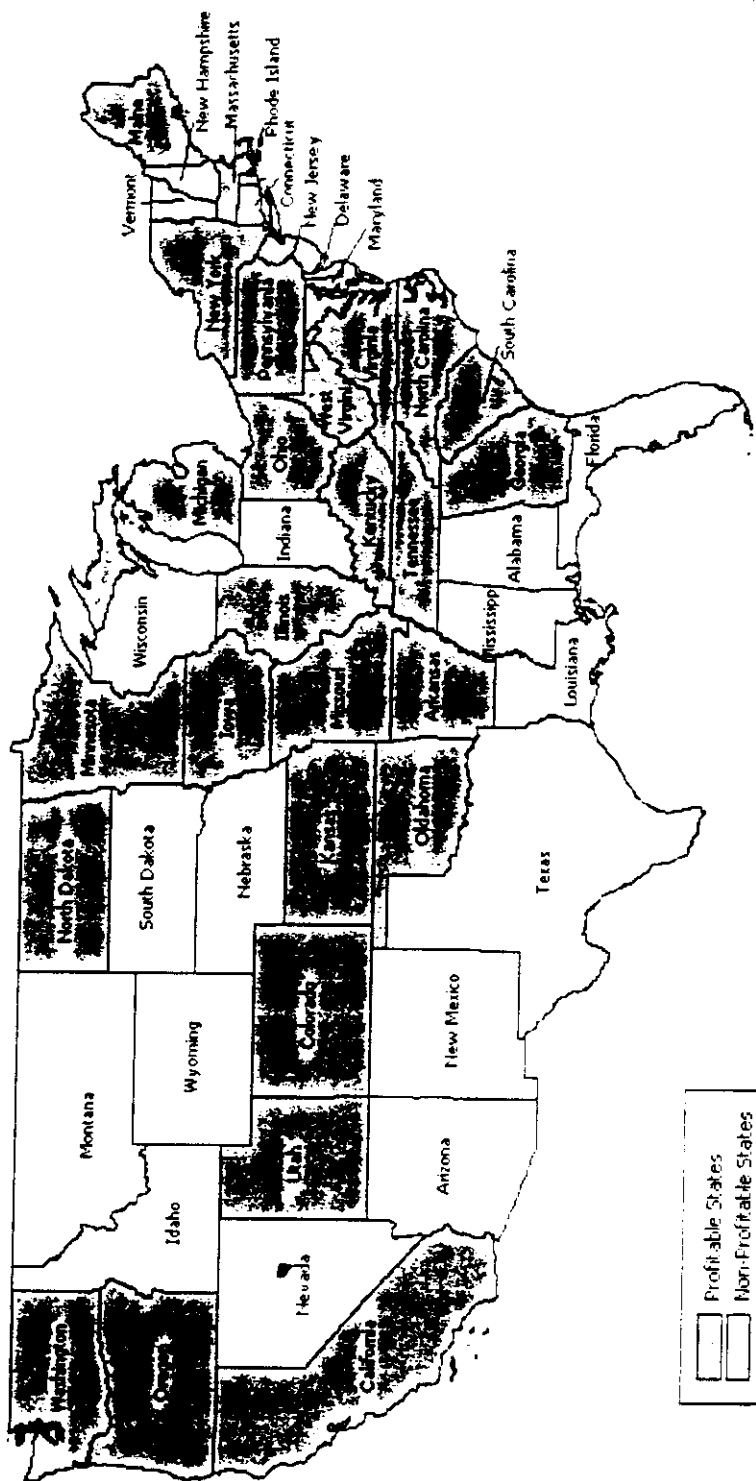
- UNE-P lines generate negative EBITDA in 18 states for the Bells (60% of US residential lines)
- SBC's Ameritech region is the most attractive for UNE-P competitors

## ◆ UNE-P Line Growth Will Be Greater than the Market Expects

- UNE-P lines can be profitable in 33 states, suggesting further entry (82% of US residential access lines)
- AT&T presents the most significant threat.
  - Its 40% share of the consumer LD market presents an immediate target
  - AT&T sees opportunities in 14-17 states, but announced entry in 8 states.
- The Bells exited 2Q02 with 7.5M UNE-P lines (5% penetration).

	2000a	2001a	2002e	2003e	2004e	2005e
UNE-P Lines	2,923	5,652	11,152	18,146	22,367	25,136
UNE-P Penetration	1.7%	3.4%	7.2%	12.2%	15.2%	17.3%

# UNE-P Economics: Summary Findings



# UNE-P Economics: Summary Findings

## ♦ Long Distance Opportunity is Only a Partial Offset

- Bells only need to add 1.3 long distance customers for each UNE-P line added to breakeven at *revenue* line
- However, the Bells need to add 5.4 long distance customers for each UNE-P line added to breakeven at *EBITDA* line
- **UNE-P IS AN EBITDA STORY, NOT A REVENUE STORY**

	<u>2002e</u>	<u>2003e</u>	<u>2004e</u>	<u>2005e</u>
LD subs	19,905	34,524	41,460	45,223
UNE-P subs	11,152	18,146	22,367	25,136
LD subs / UNE-P subs	1.8	1.9	1.9	1.8

## ♦ We Do Not Expect Near-Term Regulatory Relief

# UNE-P Economics: Summary Findings

## ♦ Anticipate that EPS Will Decline in 2003 for the Bells

- EPS highly sensitive to growth in UNE-P

	Revenue lost	EBITDA lost	EPS Impact assuming local line loss of				Free Cash flow Impact			
	per line / mo	per line / mo	1M	2M	3M	5M	1M	2M	3M	5M
SBC	\$19.76	\$17.04	\$0.04	\$0.08	\$0.12	\$0.20	\$137	\$274	\$411	\$685
VZ	17.89	15.26	0.04	0.09	0.13	0.22	123	245	368	614
BLS	18.29	15.65	0.06	0.13	0.19	0.32	126	252	377	629
Q	14.73	11.98	0.05	0.09	0.14	0.24	96	193	289	481

- We estimate that 8M lines lost translates into \$1B OpFCF loss

## ♦ Summary

**Poor Economics of UNE-P + Higher UNE-P Line Loss  
= Lower Profit and EPS for the Bells**



## UNE-P Economics: Calculating the Impact

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- 1) Calculate Revenue Impact Per Line Lost**
- 2) Estimate Average *Retail* COGS and SG&A per Line Based on Existing Wireline EBITDA Margins**
- 3) Calculate Wholesale EBITDA Contribution**
- 4) Estimate Future Line Loss in Each State**

# UNE-P Economics: Calculating the Impact

## 1) Calculated Revenue Impact Per Line Lost

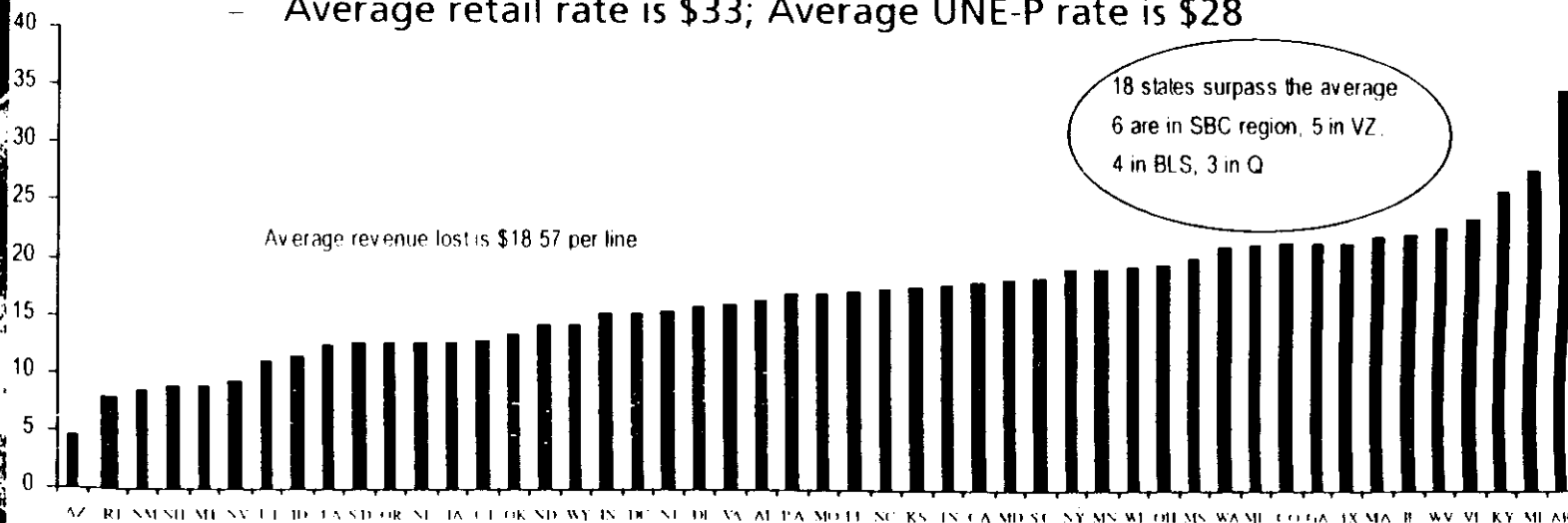
Local service revenue =	+ Basic local + Vertical Features + Access/IntraLATA toll + SLC + LNP, 911 and other surcharges	Retail Revenue
UNE-P revenue =	+ Loop + Local switching (fixed & variable) + Tandem switching + Transport	Wholesale Revenue
Difference =	Total revenue lost	

Source: UBS Warburg LLC and company reports

# UNE-P Economics: Calculating the Impact

## ◆ Revenue Lost Per UNE-P Line

- Arkansas (SBC) - \$35
  - Average retail rate (including vertical services and subscriber line charges) is \$51; Average UNE-P rate is \$16
- Arizona (Qwest) - \$5
  - Average retail rate is \$33; Average UNE-P rate is \$28



Source: UBS Warburg LLC and company reports